1-1-1928

Special bulletin no. 29 (1928, January); Appraisal of fixed assets; Canning costs; Contingent reserves; Corporation accounting; Corporation finance; Depreciation of greenhouses; Laundries cost accounting; Participation mortgage bonds; New York franchise tax bill

American Institute of Accountants. Library and Bureau of Information

American Institute of Accountants

Library and Bureau of Information

JANUARY, 1928 SPECIAL BULLETIN No. 29

[The Committee on Administration of Endowment authorizes the publication of special Bulletins, of which this is one, on the distinct understanding that members are not to consider answers given to questions as being official pronouncements of the Institute, but merely the individual opinions of accountants to whom the questions were referred. It is earnestly requested that members criticize freely and constructively the answers given in this or any other Bulletin of this series.]

APPRAISAL OF FIXED ASSETS

Q. A manufacturing corporation has acquired, January 1, 1924, machinery to the amount of actual cost, new, $300,000.00.

Their balance-sheet as of June 30, 1927, as follows:

Machinery	$300,000.00	
Less, 2½ years depreciation at rate 10 per cent	75,000.00	
Net worth as of June 30, 1927		$225,000.00

For the purpose of issuing bonds they were compelled to call in a reputable firm of appraisers, and they placed the market value or net worth as of June 30, 1927, at $317,000.00 on this machinery.

Can this corporation in their calendar year statement, i. e., December 31, 1927, take the amount of the appraised value as submitted by these appraisers, i. e., $317,000.00, as the value of this machinery and set up as a surplus the difference of $317,000.00, less $225,000.00, $92,000.00?

A. The difference between the sound value as appraised and the depreciated residual cost of the plant represents an appreciation of value in the nature of an unrealized profit. Conservative practice demands that such an unearned profit should not be buried in earned surplus if brought upon the books, or, at any rate, the fact that appreciation has been given effect to in the accounts should be disclosed in some form or another in the balance-sheet. The exact manner in which such a transaction should be treated depends upon the individual case, depending to a great extent upon whether the appraisal is incident to the acquisition of fixed assets by a new corporation, incident to a change in the capital structure of a corporation, or purely an appraisal of fixed assets involving no other changes of the nature described. It is stated in the instant case that bonds are about to be issued, and in order that the public buying bonds may be well informed as to the true value of the property, it would be highly desirable to give effect in the balance-sheet to the appraised value. However, the appraisal in this case has no relation to a change in capital stock or the transfer of title to the property. The description of the fixed assets, therefore, should make reference to the fact that the machinery has been appraised and that the values stated are the appraised values. Per contra, the appreciation should properly appear in a separate division of surplus account entitled "surplus arising from appraisal of fixed assets," or some similar title.

Such unrealized profit or appreciation is specifically exempt from federal income tax under the revenue act of 1926, and, per contra, the allowable deduction for depreciation with respect to such assets is restricted to an amount which will amortize out of profit the cost of acquisition of such assets. The amortization of the appreciation should be provided over the remaining life of the assets by charge against the surplus arising from appraisal.

May we say in closing that in our opinion, under present accepted principles of finance and accounting, the operating accounts of a business are responsible only for the amortization of the cost of acquisition of fixed assets. To charge operations, and ultimately penalize earned surplus, with the amortization of appreciation is incorrect. Many political economists, appraisers and a few accountants hold opinion to the contrary. The problem is one of the moot questions of the present time, and every one admits much of the practical logic which supports the contentions of those advocating the amortization of appraised values out of earnings. In the instance of the appraisal of fixed assets to be acquired the situation is quite different. In such a case, the appraised value becomes the cost of acquisition. Surely, in connection with a change of capital structure, being in the nature of a reorganization, as a result of which capital stock is issued against such appreciation, there remains but one course out of which to provide for the amortization, namely, out of earnings. As a general rule, the term surplus, unless otherwise qualified, should represent surplus arising from earnings, and, per contra, such surplus should be charged with amortization sufficient to extinguish the cost of acquisition of fixed assets.

CANNING COSTS

Q. In connection with the cost accounting of a canning factory which packs corn principally, is it the common procedure to departmentalize or treat the entire operations as a whole? If departments are set up, what is the correct basis for apportionment of overhead expenses, or if entire operations are treated as a whole, what is the correct apportionment for various overhead items?

A. Final costs cannot be prepared more often than once a year, owing to the fact that the packing season is of short duration, whereas the overhead expenditure is constant.

Costs are departmentalized in so far as they apply to factories, which in turn are broken down in various products, those in turn being broken down into various sizes of containers.

Factory overhead is allocated to factories according to actual figures per accounting records, or if actual figures cannot be determined, then it is prorated on the basis of pack. General overhead is also pro-rated according to pack.

Labels, labeling, warehouse and shipping costs are allocated on basis of actual figures for factories or, if not known, according to cases shipped. Selling expenses embracing commission, brokerage, salesmen's salaries and expenses, swells and allowances, cash discounts, are allocated on a dollar value on the shipments from the individual factories.

Costs are broken down by factories to various products on the following basis:

Raw material, labor, boxes, cans and jars—Actual.
Coal and power—On a basis calculated on the time necessary to cook the product, in relation to a base time.
Factory and general overhead—Arbitrary figures may be used but the basis should be "pack" quantity.
Labels, etc.—On shipments.
Freight out—On tonnage shipped.
Selling expenses—On sales value of sales.

The costs are broken down into sizes on the ratio of the capacity of the container to a No. 2 can. All items with the exception of the following are pro-rated on that basis.

Boxes, cases and jars—Actual being used.
Labels, etc.—Actual being used.
Selling expenses—Sales values being used.

All costs are worked out on a base figure which is taken as a No. 2 can, and then broken down into sizes according to the previous paragraphs.

A. In 1920 the National Canners Association put out Special Bulletin No. 3, which provides for departmentalizing of commodities so far as prime costs are concerned, and so far as direct factory expense is concerned. Prime costs, of course, can be charged without hesitation to cost of the single commodity packed. Certain factory expenses can be charged direct to the product, such as

(a) Royalties, rentals and other expenses in connection with the machines used exclusively for corn.
(b) Miscellaneous factory expense and repairs chargeable directly to corn.
(c) Setting up or taking down machinery used only in packing corn.
(d) Small tools and appliances used exclusively on corn.

Quoting further from this classification, which by the way is out of print:

> "Some accountants may ask, 'Why have "Corn Factory Expense" for instance?' 'Why not charge all factory expense to general factory expense account No. 75 and at the end of the year distribute the total to the commodities on the basis of the pack?' If this view is persisted in it will, no doubt, save a little bookkeeping; but the results under such conditions will be grossly inaccurate. Charge all items that clearly belong to specific commodity expense accounts to those accounts at once, and charge to general factory expense account only items that cannot be said to belong to one particular commodity."

Factory expense of the sort that benefits all products is distributed at the end of the year to the commodities on the basis of quantities packed. Some items perhaps may be divided on a more equitable basis where a division on the basis of relative quantities packed would be manifestly unfair. In most instances, however, the per dozen or per case basis of distributing general factory expense is usually employed. General expenses paid are distributed on the quantity basis rather than on the basis of relative aggregate sales values, or prime cost, or productive labor costs.

As to cost of distribution, brokerage and sales allowances can be charged direct against the specific commodity. Selling expenses applicable to all commodities are apportioned in proportion to quantities sold.

CONTINGENT RESERVES

Q. Company X on December 31, 1925, prepared and published a profit-and-loss account showing a net profit of $X, which was transferred to surplus account. At the same time there was charged to surplus account a sum of $Y, designated as "reserve for contingencies," which officers of the company then stated as intended to cover general and at that time unforeseen contingencies. Inventories of materials used in manufacturing were valued at cost. During 1925 certain contracts had been made for materials for future delivery, part of which were received by the company in 1926.

Since January 1, 1926, a very substantial drop has taken place in the market prices of such raw materials and the company feels that its earnings have been seriously affected by the relatively high value of raw materials carried over in inventory and by commitments entered into in 1925.

With a view to determining the proper set-up of its accounts for 1926, some discussion has arisen and the company has obtained a number of published statements of accounts of companies engaged in the same line of business certified by various leading accountants. As a result the following questions have arisen relative to the summarized annual statements which it intends to publish:

(1) Can the manufacturing costs with propriety be reduced by the above mentioned sum of $Y and the actual net profit from operations for the year be increased accordingly?

(2) Can the above mentioned sum of $Y with propriety be included as a credit in profit-and-loss account under a designation of reserve brought forward for fluctuation in prices in determining net profit carried to surplus account?

(3) Should the above mentioned sum of $Y merely be credited to surplus account whence it was originally transferred in 1925?

A. In the following we are assuming that both inventories and commitments were at the lower of cost or market as of the close of 1925 and that no part of the reserve for contingencies now under discussion was to cover an excess of cost over market on either of these items.

(1) In our opinion manufacturing costs for the year cannot with propriety be reduced by the reserve for contingencies set up as at the close of the preceding year without incorporating in the body of the published profit-and-loss account or as a footnote thereon a brief explanation of what has been done; and, even in this case, the caption opposite the final amount on the profit-and-loss account for the year which ordinarily would read "Net profit for the year" should undoubtedly have a few words inserted therein—for example, "On the above basis" or "See footnote," directing the attention of the reader to the more detailed explanation of what has been done, appearing elsewhere in the account.

(2) We see no objection to applying the reserve for contingencies, set up at the close of 1925, as a special credit in the 1926 profit-and-loss account below the "Net profit for the year" if a brief wording is inserted explaining that this reserve has been applied to offset the extraordinary losses due to fluctuations in prices. We think this method preferable to that referred to under (1) above.

(3) We think it a better plan than either of these referred to in (1) and (2) to transfer the reserve for contingencies directly back into surplus, and one much less likely to be misunderstood or misconstrued by outsiders reading the published accounts.

CORPORATION ACCOUNTING

Q. A holding corporation has an operating deficit of $54,000. A consolidated balance-sheet of the holding corporation and all subsidiaries shows a surplus of $10,000, after elimination of all inter-company profits. The holding corporation owns all the capital stock of the subsidiaries.

Subsidiary corporation "A" has a surplus of $67,000, all resulting from increase of fixed-asset value, as reported by competent appraisers. The holding corporation's deficit is the remainder of a former larger deficit, after being cut down by a profit of $15,000 during the year recently closed.

The holding corporation carries its capital stock in subsidiary corporation "A" at its cost, which is par.

The holding corporation desires to pay a dividend. It proposes to write up the value of the stock in subsidiary corporation "A" to equal the book value of the stock, which they consider a sound and actual value. The holding corporation would then show a surplus of $13,000.

The writing up of this stock would cover the deficit, and in addition release $13,000 of the $15,000 profits of the last year as available for dividends. It is my understanding that the procedure is proper, although perhaps not to be considered as a conservative manner of doing business.

A. The most feasible way, in our opinion, of handling the above situation would be to have the subsidiary corporation "A" declare a dividend to the holding corporation, in the amount of its surplus, either in cash, if sufficient cash is on hand, or if this is not the case, then to increase its authorized capital stock in the amount of the existing surplus, and then declare this as a stock dividend to the holding corporation. Thus a surplus would be created on the holding corporation's books in the amount of $13,000, which could then be declared as a dividend. We think that this method is preferable to the method proposed in the question.

We agree with the writer that the procedure as set out could hardly be considered conservative. The question as framed does not state the causes for the increase in value of fixed assets in subsidiary corporation "A," nor does it state whether or not similar appraisals were made of the fixed assets of the other subsidiary corporations. If so, and these latter showed their assets to be worth approximately the values carried on the books and if the increase resulting from the appraisal of "A" corporation's fixed assets was due to excessive depreciation rates having been charged over the expired life of these assets, in this event the procedure proposed by us would seem to be technically in order, and the dividends could be defended under New York practice. If, on the other hand, "A" corporation had its fixed assets appraised, and wrote them up as a result of the appraisal and the other subsidiaries had no appraisals made of their fixed assets, it is quite possible that there would be offsetting adjustments in the plant accounts of the other subsidiaries due to overvaluations existing on their books. Under this condition the procedure would not appear to be either conservative or defensible.

From a legal standpoint the question arises as to the right of the directors to declare dividends out of a surplus created as the result of a revaluation of capital assets. We understand from New York attorneys that under the laws of that state dividends can be declared out of surplus arising from such sources. We are not sufficiently familiar, however, with the laws of other states to say whether or not this would apply throughout the country.

CORPORATION FINANCE

Q. We have two or three clients who make it a practice to increase the book value of their affiliated companies to cover their proportion of their earnings, crediting the same to their income account and paying dividends out of it.

In the case of a company that owns all of the preferred stock of a company and 50 per cent. of the common stock, all of the voting power being in said common stock, is it proper for the parent corporation to increase the book value at which they are carrying said common stock with their pro-rata of the earnings for any particular period and credit same to an income account, using said income with which to pay dividends? Some of our clients make a practice of doing this, although the partly owned affiliated company is not in position to pay out any cash dividend; in fact, said affiliated company in one of two instances is more or less heavily indebted to banks.

A. There are two principal methods of handling profits and losses of subsidiaries on the books of a holding company, both of which are considered good accounting: (1) the investment is carried at book value, and profits and losses of subsidiaries are taken up on the holding company's books from time to time; (2) the holding company's investment in subsidiaries is carried at cost.

Under method (1) the investment account would be debited with the book value at date of acquisition and subsequently debited for subsidiary profits and an income account credited, the latter account being closed into surplus. The investment account would be credited also for losses suffered by subsidiaries or for dividends disbursed by subsidiaries to the holding company. The investment would approximate at all times the current book value of the holding company's interest in subsidiaries.

Although profits of subsidiaries increase the holding company's net worth, such profits are not available for distribution as holding company dividends as long as the subsidiary elects to reinvest its profits in the business rather than to distribute them as dividends. It is not sound finance for a holding company to declare a dividend on an increase in net worth which is retained by subsidiaries and invested in the business of those companies.

The holding company, therefore, should limit its dividends to the amount of dividends actually received from subsidiaries. But there is still another limitation. For example, in one instance the parent company A owned the entire capital stock of subsidiaries B and C. B made a substantial profit and declared a dividend thereon. C suffered a loss so that the condition of the organization in its entirety as represented by consolidated statements did not warrant the payment of a dividend. Nevertheless A ignored the loss of C, took up the dividend from B as income and declared a dividend out of the resulting profit. The principle that a holding company may distribute dividends to its stockholders to the extent that dividends are received is appropriate, therefore, only when the amount distributed does not exceed the net aggregate profits of the subsidiaries.

Under method (2) the subsidiary investment account on the books of the holding company is carried at cost. Profits and losses of subsidiaries are not recognized on the holding company's books. Dividends received from subsidiaries are credited as income on the books of the holding company. The holding company may properly declare dividends on the basis of such income subject to the limitations discussed in the third paragraph under method (1).

DEPRECIATION OF GREENHOUSES

Q. What are the rates of depreciation customarily taken on greenhouses constructed with concrete foundations and steel frames?

Seven and one half per cent. yearly was taken by a client for the period 1919 to 1922, and without question by the income-tax unit. However, for 1923 the rate has been questioned and after conference a rate of 5 per cent. was allowed. I am not altogether satisfied that this 5 per cent. rate is fair to the client.

A. We had never been able to find any official information regarding rates of depreciation which would apply with reasonable accuracy to greenhouses. We have, however, discussed the probable life of greenhouses of different types of construction with greenhouse men and we have reached the opinion that greenhouses built upon a concrete foundation with steel frames, kept in good repair, could reasonably be expected to have a life of twenty years as a minimum.

Accordingly, it has been our practice to use a depreciation rate of 5 per cent. on the greenhouses and on the heating plant. To offset this moderate depreciation rate, in sections which are occasionally visited by hail storms, the repair charges may prove to be heavy, and it may even be advisable to raise the depreciation rate so as to equalize this charge to some extent. Such damage, however, is restricted to relatively small areas.

LAUNDRIES COST ACCOUNTING

Q. We have several prospective clients in the state who are operating small laundries and feel unable to install a complete cost system such as is prepared by the National Laundrymen's Association.

One of them has suggested the possibility of providing for tests of the costs whenever they feel disposed to make them.

A. Test costs must always be accepted with reservations and more especially so when no attempt is made to reconcile them approximately with actual expenditures. On account of fluctuations of business in laundries the value of test costs would depend to a large extent on the judicious selection of the time chosen for making the tests and even then extreme care would require to be exercised to see that due allowance had been made for all indirect as well as direct expenditures.

PARTICIPATION MORTGAGE BONDS

Q. The X Mortgage Company is practically ready to place some participation mortgage bonds on the market. In fact, they have some customers on the waiting list for some at this time.

If it can be done without hurting the sale of these bonds, they would like to have a provision in their trust agreement, or in their prospectus, or in the bonds themselves, that the ratio of bonds issued to the capital stock and surplus of the corporation shall not exceed a certain figure which should be, perhaps, not in excess of five to one, possibly three to one.

The question that is perplexing us and on which we would like to have your counsel is: Will such a provision be, in your opinion, detrimental in the selling of these bonds? Probably in most cases this question would not enter the mind of a purchaser, and on the other hand, if introduced by the X Mortgage Company, it might appear to be an effort to bolster up their collateral and therefore we are rather at a loss to know just exactly what is the proper thing to do under the circumstances.

It is our opinion that these bonds are absolutely good so long as they are held within a reasonable limit. However, we do not wish to leave open an avenue whereby it would be possible for an excessive issue to be sold which would, of course, weaken the guarantee which stands behind these securities by increasing the ratio of bonds to capital.

We will very greatly appreciate your counsel in this matter, and to avoid any possible misunderstanding, will state that the X Mortgage Company does not expect to issue many bonds at this time and will be rather surprised if they have as much as $100,000.00 worth of them to offer within the next twelve months.

Will you also advise whether or not "Participation Mortgage Bonds" is a correct name for this particular kind of a bond. The word "Participation," we think, seems to convey that the bonds would participate in profits and we want to be sure that there can be no legal tangle about this.

A. It appears from the question submitted that, in placing some "participation mortgage bonds" on the market, the X Mortgage Company is considering the desirability of restricting the total of the bonds to an amount such as shall not exceed a given ratio to the company's capital stock and surplus, the restriction to be embodied in the trust agreement, or the prospectus, or the bonds themselves. The ratio in mind is "not in excess of five to one, possibly three to one."

The question perplexing the inquirer is: Will such a provision as is contemplated be detrimental to the sale of the bonds?

It is our opinion that the stated provision would make for a sounder capital structure than would be the case otherwise and, therefore, instead of being a hindrance it should promote the sale of the bonds. We are, of course, confining ourselves to this particular feature of the issue. Further, we believe that a ratio of 5 : 1 is high; the lower ratio of 3 : 1 is more acceptable.

The second question is too vague in its terms to permit an explicit answer. If, as appears to be the case, the bonds are the direct obligation of the company, issued under an agreement between the company and the trustee and secured by the deposit and assignment of mortgages acquired, we do not think the word "Participation" should form part of the description. "Participation" might be construed as meaning a sharing in something—profits; at any rate there is that possible hazard, to avoid which we suggest a more suitable designation. If the bonds are of the nature outlined above, we suggest "Collateral Trust Mortgage Bonds" as an appropriate description.

NEW YORK FRANCHISE TAX BILL

Q. New York franchise-tax bill for the year ending October 31, 1927, is received in December dated December 20, 1926. Should this invoice be entered in the accounts in 1926 and a prepayment shown for the ten months of 1927, or should the bill be excluded from the accounts and an accrual for two months of 1926 shown on the December 31, 1926, balance-sheet? The latter based on the assumption that a prepayment must result from an actual expenditure of cash.

A. The New York franchise tax is a liability on November 1st of each year. If the bill is received in December, it should therefore be entered up as a liability, and a deferred charge for 5/6 of it may be carried forward. Deferred charges do not necessarily mean cash prepayments and since the tax bill is received before the close of the year and will have the effect of reducing the cash and increasing the liabilities, it should be shown in the balance-sheet.